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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0247
INCOME TAX
FOR TAX PERIODS: 1994-1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

Issues

1. Income Tax: Imposition of Gross Income Tax

Authority: IC 6-2.1-2-2, IC 6-2.1-1-2 (c), IC 6-8.2-5 (b), 26 USCA 707 (a) (2) (B), 26 CFR Sec. 1 707-3(c), (d), Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.
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The taxpayer protests the imposition of Gross Income Tax on certain receipts.

2. Income Tax: Construction allowances

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2 (b).

The taxpayer protests the imposition of tax on construction allowances.

3. Income Tax: Taxation of Corporate Partner

Authority: IC 6-3-4-14, 45 IAC 3.1-1-153.

Taxpayer protests the method used to compute its share of partnership income attributable to Indiana.

4. Tax Administration: Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16.

Taxpayer protests the imposition of penalty.

Statement of Facts

The taxpayer, an operator of retail clothing stores, files a consolidated return which includes several related retail clothing stores. After a routine audit, the Indiana Department of Revenue assessed income tax, interest and penalty against the taxpayer. The taxpayer timely protested the assessment and a hearing was subsequently held. Further facts will be provided as necessary.

1. Income Tax: Imposition of Gross Income Tax

Discussion

Indiana imposes a gross income tax on the receipt of gross income pursuant to the provisions of IC 6-2.1-2-2 as follows:

> (a) An income tax, known as the gross income tax, is imposed upon the receipt of:
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> (2)the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana.

An exclusion from the gross income tax is provided at IC 6-2.1-1-2 (c) as follows:

> The term “gross income” does not include:
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> (14) The receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to capital thereof. . . .”

This statute is further explained at 45 IAC 1-1-58 as follows:

> Contributions of capital to a corporation, joint venture or partnership are exempt from gross income tax. No gross receipts result to the recipient of the capital and none result to the donee upon his receipt of stock in exchange for the capital.

Indiana Department of Revenue assessments are presumed to be correct and the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b).

All exemptions must be strictly construed against the party claiming the exemption. Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer, and two other corporations, corporation "A" and corporation "B", contracted to transfer assets to a limited partnership. The taxpayer and corporations "A" and "B" received cash from the limited partnership as a result of the transfer. The Indiana Department of Revenue assessed gross income tax against the total amount received by the taxpayer in the transaction. The taxpayer contends that the receipts are not subject to the gross income tax because they were received in exchange for a contribution of capital. The issue to be determined is whether the taxpayer's receipts were taxable gross income or nontaxable contributions of capital.

Pursuant to the law and regulation, contributions of capital do not result in gross income to either the recipient of the capital or the contributor. Therefore, the taxpayer is correct when saying that if the transfers were contributions of capital to a partnership, the monies received in exchange for those capital contributions would not be subject to gross income tax. The facts in this instance, however, do not support the conclusion that the situation under examination was in reality a contribution of capital.

Rather, the facts indicate that the taxpayer actually sold assets to the partnership. The taxpayer reported the funds received as income on its Federal Income Tax return. The partnership's Securities and Exchange Commission Annual Report for fiscal year ended January 29, 1994 referred to the transfer of assets as an "acquisition" by the partnership. Page 7 of that Annual Report states as follows, "Financial data for the twenty-six weeks ended January 29, 1994 reflects the effects of adjustments to historical asset values as required by the purchase accounting method , interest expense relative to the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition. . ." As income received from a sale, the taxpayer's income is subject to the gross income tax.

In the alternative, the taxpayer contends that if there is no contribution of capital to the partnership treatment, then the income must be treated as a distribution from a partnership. However, that does not comport with the federal law and regulations. Pursuant to IRC Sec, 707 (a)(2)(B), when a partner transfers property to a partnership and there is a related transfer of money to that partner from the partnership, it is a disguised sale rather than a contribution of capital or partnership distribution. The selling partner is required to recognize gain or loss on the disguised sale. Whether a transfer constitutes a disguised sale is a question of fact. Pursuant to 26 CFR Sec. 1.707-3 (c) and (d), such a transfer is presumed to be a disguised sale rather than a partnership distribution if the contributions and distributions are made within a two year period. The taxpayer and the partnership made the contributions and distributions within a two year period. Therefore, the Department finds the transaction to be a disguised sale. The taxpayer owes gross income tax on the income received in the transaction.

Finding

The taxpayer's first point of protest is denied.

2. Income Tax: Construction allowances

Discussion

Shopping center owners/developers often grant construction allowances to desirable tenants to induce them to locate in their shopping centers. In this instance, the mall developer gave to the taxpayer, as a construction allowance, money to cover the taxpayer's expenses in modifying the leasehold to suit the business purposes of the taxpayer. The Indiana Department of Revenue assessed tax on those receipts. The taxpayer contends that the construction allowances are capital contributions and not subject to tax. IC 6-2.1-1-2 (c)(14).

The regulations promulgated by the Indiana Department of Revenue in effect during the tax period, 1994-1996, did not contain any examples. However, the most recently promulgated regulations concerning capital contributions do contain examples. Specifically 45 IAC 1.1-6-5 (c) (3) gives the following example of a contribution to capital.

> (3) A contribution by a shopping center developer of land and building costs to a corporation to attract it as the anchor tenant for a shopping center.

This example of a non taxable capital contribution is similar to the contribution received by the taxpayer. Therefore, the construction allowances qualify as non taxable capital contributions. The money received by the taxpayer which was in excess of the actual costs of the modification of the leasehold is not, however, a contribution of capital. Rather, it is income subject to tax.

Finding

The taxpayer's second point of protest is sustained in part and denied in part.

3. Income Tax: Taxation of Corporate Partner

Discussion

The taxpayer, a corporate member of a partnership, has characterized the income received from the partnership as business income from a unitary business. As such, the taxpayer computed its partnership income attributable to Indiana pursuant to 45 IAC 3.1-1-153 (b).

During the last two years of the audit period, 1995 and 1996, the Department made an adjustment on the audit to reflect the Department's conclusion that the partnership's activities no longer constituted a "unitary business under established standards." Specifically, in 1994, partnership rental income was allocated to the corporate partners in proportion to each partners' equity interest. But in 1995 and 1996 this method of allocation changed. One hundred percent (100%) of the post-1994 partnership rental income was allocated to a non Indiana partner. This change led the Department to conclude that the taxpayer and the partnership were no longer engaged in a unitary business. Consequently, the Department recomputed the taxpayer's partnership non-rental income (actually deductions) attributable to Indiana pursuant to 45 IAC 3.1-1-153 (c).

After reviewing the file and subsequent correspondence, the Department agrees with the taxpayer that the partnership's activities or the partnership's relationship with its corporate partners, including the taxpayer, did not change enough to deny a unitary business filing status for the audit years 1995 and 1996.

Finding

The taxpayer's third point of protest is sustained.

4. Tax Administration: Penalty

Discussion

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

In this instance, the taxpayer was negligent in including a value for certain Indiana property in the denominator of the property factor and making no attempt to include any amounts in the numerator even though the company was based in Indiana.

Finding

Taxpayer's protest is denied.

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